Real Charitable Choice

The charitable sector is under increased scrutiny. Partly because of complaints about excess claims of charitable deductions taken by taxpayers, some questionable payments to board members of foundations and other charitable officials, and inefficient practices and excess administrative costs, the Senate Finance Committee staff has put forward a set of proposals for consideration by the Congress.

This isn’t the first time in recent memory that attention has been paid to the charitable sector. Partly due to proposals put forward by President George W. Bush and then-presidential candidate Al Gore, both houses of Congress as early as 2001 began to consider fashioning bills to expand incentives for giving. Unlike the proposals now being considered, which generally restrict actions and at times take things away from charities, the former effort focused on increasing their resources. That bill has languished; each year, Congress has decided it had higher priorities for the types of tax cuts it wanted.

So also is the new bill likely to languish, at least until the next Congress is elected. There are so few legislative days left in the year, and the members haven’t even fixed on a set of proposals to incorporate in a bill. Some provisions attempting to get at some abuses in donations of automobiles have made it into separate legislation that might be passed this year, and even that is in doubt. I suggest that most or all of these efforts ought to be combined and that bipartisan work throughout the remainder of this year should be devoted to this merger of efforts. A combination provides opportunities not available when restrictions and incentives each are considered separately. The standard for judging the merit of the proposals in a united bill should be what it does as a whole to add to the amount on net that goes for charitable purposes relative to the revenue cost to the American taxpayer. I don’t mean to imply that this is the only standard, that it is always easily quantifiable, or that value is not also added by administrative efforts aimed at improving charitable outcomes, but the standard does provide at least a common framework for assessing merits of proposals. Consideration of trade-offs, or benefits relative to costs, essentially increases the probability that more charitable dollars will go to meet societal needs.

I confess I also have a political motivation for wanting to combine the bills — political in the sense of increasing the likelihood of getting good legislation passed. A combination bill aimed simultaneously at increasing giving and making the money more likely to reach charitable beneficiaries gives Congress and the charitable sector a way of bargaining that goes beyond the one-item-at-a-time fighting over who might be losers in the process.

When losers draw most of the attention, members of Congress tend to back off and avoid offending interests. They might attack outright abuse but become reluctant to fight inefficiency. By the same token, in a one-at-a-time world, the representatives of the charitable sector are pushed to behave like a trade association — often having to represent identifiable losers rather than the broader sector, where potential winners from a strengthened sector are more amorphous and fight less for their gains.

The net amount for charitable purposes is clearly a far more important consideration than the gross amount flowing through any particular charity. For instance, suppose a provision forces some charities to lose $100 of contributions, of which only $25 really ends up going to charitable recipients. Often the charity in question will end up fighting to protect the $100 going through its organization, with the notion that at least some money is going for good purposes. Suppose also that Congress offers charities as a whole in exchange subsidies likely to increase giving inuring to charitable beneficiaries by $30. Then, charity as a whole likely comes out ahead, not only because there is more money available to ultimate beneficiaries, but also because the economy as a whole is now more efficient and wastes fewer resources along the way.

A complex part of this equation requires consideration of the reputation of the sector as a whole. If a leaner and cleaner sector leads to more giving by the public, then that must be counted strongly on the benefit side of the equation. Admittedly, qualitative judgment is required. As an example, if some levels of compensation are considered excessive, then a judgment must be made as to whether a restriction on compensation mainly yields more on net for charitable purpose or less in charitable output (over and above compensation) by those whose compensation is restricted.

Among the specific items to which the Senate Finance Committee has recently turned its attention are limitations on compensation of foundation board trustees. Admittedly, some foundation trustees might at some level be worth what they are paid. But, remember, that is not an adequate argument. In the first place, their value added must exceed that of alternative board members who might be contributing services for nothing. If restriction of this compensation prevents some abuse, or simply prevents some other trustees from being paid more than they are worth, then there may be a net gain from the restriction — even though there are exceptions along the way.

Now turn to the earlier set of proposals and bills to try to increase charitable giving, such as a deduction for those who do not now get one because they do not itemize and an automatic exclusion for contributions given out of individual retirement accounts. When I...
ABUSING THE CHARITABLE DEDUCTION: THE CASE OF AUTOMOBILE DONATIONS

Congress has paid attention recently to abuses associated with the donations of automobiles to charities. Anyone who listens to the radio must know that large third-party brokers, using substantial advertising dollars, have gotten into this business in spades. It is important, however, to recognize that there are really two separate problems. One is that individuals often overvalue their automobiles. The other is that often a very large deduction is taken for what sometimes amounts to very little for ultimate charitable purposes. This distinction can be seen through an example. Suppose an automobile with a wholesale value of $500 (what a car dealer would give an individual) and full retail value of $1,000 is given to a charity through a third-party broker or marketing firm. The marketing firm spends $300 for advertising, pockets $100, and gives $100 to the charity for the use of its name. The individual thinks generously about the value of the car, assesses it at full retail blue book value without adjustment for dents and scratches, and then deducts $1,200 on his tax return. The deduction results in savings of federal taxes of $300 and state taxes of $50.

There are several bad consequences here. One is inequity. It is not simply that the government loses $350 to give $100 to a charity. Government is just an intermediary; other taxpayers are the real losers. The $350 worth of tax breaks going to the contributor in this case means that other taxpayers either fork over an extra $350 in taxes to cover the cost of government or receive $350 less in expenditures — all for only $100 more to charity. A second is inefficiency. Many of those extra advertising and marketing costs yield nothing on net for society. That labor could have been spent better developing products useful to consumers. Measured correctly, net national product is actually reduced by these transactions. A third consequence is the weakening of ethics within the charitable sector itself. One is reminded of the case of savings and loans that were led to compete with each other, offering interest rates on accounts well above market, simply because some aggressive leaders began to attract funds in an unethical manner. Similarly, charities begin to learn the power of advertising that in my book should be labeled as misleading, since potential donors generally are not told how little of their contributions are going to charity. But if one charity spends an enormous amount on advertising, it is hard for another not to compete. After all, the third-party brokers require nothing of them but to give them their name — their good name, that is. Thus, charities who want to avoid this type of market might find that they have to advertise more and more to compete with the most aggressive charities within the sector.

In the end, the reputation of all parts of the charitable sector is weakened, probably reducing giving as a whole. Those individuals who don’t engage in these types of activities come to question the integrity of charities and begin to give less. But we are not done yet. Think about what happens to the giving habits of those who do donate the automobiles. Certainly their in-kind gifts are likely to displace some other giving they would otherwise undertake. In the above example, the taxpayer giving away the automobile with a retail value of $1,000 only has to reduce other giving by $101, and there is less on net available for charitable purposes (recall that the charity only ended up with $100 from the automobile). Now the charity getting the $100 may still come out ahead, but the sector as a whole loses. Thus, those fighting to retain most of the status quo need to be very careful not to engage in the fallacy of composition, thinking that what is bad for some charities is bad for charities as a whole.

If you follow through the various negative consequences I have listed above, you will see that they can be quite large on net. If you believe, as I do, that these automobile donation abuses are a black eye on the sector that tends to reduce charitable contributions both by a public led to cynicism and perhaps even by the donors of automobiles themselves, then the sector may gain considerably by encouraging a crackdown on this abuse. Indeed, one has to wonder why it hasn’t done more itself already. Moreover, it is clear from the example that overvaluation is not the sole, nor necessarily even the major, issue at stake.

Note that reform here may lead both to net gains in revenues to the government and gains in net resources available for charitable purposes. Remember that there are substantial savings in marketing and advertising cost that allow both government (or taxpayers as a whole) and charities to come out ahead. If Congress does project revenue saving from a crackdown, I suggest again that it would be best if the revenue were spent on other mechanisms to improve the charitable sector, whether it means an improved set of incentives or more resources for enforcement or to facilitate electronic filing. That way, the gains from the trade-off are clearer both to elected officials making the choice and to a charitable sector debating within itself whether or not to support the reform effort as a whole.

tested on that set of proposals, I suggested a similar benefit-cost method of comparing increases in giving with revenue cost. It led me to recommend that there were more efficient ways of increasing charitable giving than current law, and without any revenue cost. The trick is to improve incentives for marginal or additional contributions and pay for the change by limits on subsidies
for the first dollars given to charity. By granting deductions for giving above a floor, for instance, Congress could spend the same amount as it does now in a way that almost inevitably increases giving.

At the same time, attention throughout a combined bill should be paid to enforcement — a clear motivation only in the current bill. For instance, the IRS simply cannot and does not spend much effort on enforcement in the charitable arena. This provides another argument for a floor under itemized deductions. As opposed to a floor, another way of tackling this enforcement problem — and then using the increased revenues to pay for incentives — would be to require that in addition to existing rules, all charitable deductions (not just donations of property) are allowed only when the individual has a formal record, through checking, charge card, or statement of the charity as to the value of the gift received. Basically, tax system enforcement just does not work well where individuals are allowed to place value on something without a back-up accounting system being kept by some other party to the transaction, whether employer or gift recipient. That enforcement dilemma should be admitted right up front.

Again, however, I would spend the revenues from improved enforcement on enhancing incentives for charitable giving. I do not have space here to go through those options thoroughly, but they include the allowance of a deduction to more taxpayers, as well as an item I have pushed for many years — the allowance of charitable deductions for any year up until April 15 of the next year (like individual retirement accounts). As noted above, by posing the problem as a trade-off, the Congress is also more likely to engage the charitable sector in a meaningful dialogue, rather than put it on the defensive. The question is no longer, “How much are you willing to give up?” It becomes, “In what way can the revenues be spent best?” Spend more where only a modest fraction inures to charitable beneficiaries, and then there is less to spend elsewhere.

Although proposed new rules on donations of automobiles have been separated into other bills, I also suggest that the revenues from the deterrence of this abuse be put back into the charitable sector — either in the form of increased incentives or increased resources for IRS enforcement. Had that trade-off been offered, I believe that it would have strengthened the political support for a tight restriction, such as allowing a deduction only for the net amount of the automobile ultimately received by the charity.

In sum, while I do not claim to have examined many of the provisions now in the disparate bills, I do think it is possible to develop a combined bill that would be better than what is now on the table and lead to a strengthening of the sector as a whole.

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